

realized as a result of the merger. MCI and WorldCom break these “synergy” savings into two broad categories: operating cost savings and capital expenditure savings.<sup>47</sup>

*Operating Cost Savings.* MCI and WorldCom identify a line item among operating cost savings called “MCI local savings.” The merged entity anticipates MCI local operating cost savings of \$500 million in 1999, rising to \$1.2 billion in 2002.<sup>48</sup>

In their public announcements and SEC filings, MCI and WorldCom do not identify anticipated MCI local operating cost savings in 2000 and 2001. However, extrapolating from the 1999 and 2002 figures that are provided in the financial documents, one might conservatively estimate planned savings in the range of \$700 million in 2000 and \$900 million in 2001. Based on this estimate, the merged entity plans a total reduction of \$3.3 billion in MCI local operating costs in the four years after the merger.

A small portion of these savings may come from merger-related efficiencies. But savings in the magnitude of \$3.3 billion over four years can only be realized by a shift in business focus, away from the high costs of marketing, provisioning, billing, and providing customer service to a mass market.

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<sup>47</sup> *Id.*

<sup>48</sup> *Id.*

*Local Capital Expenditure Cost Savings.* MCI and WorldCom also identify \$700 million in reduced capital expenditures in the local loop in 1999 and \$300 million in reduced local loop capital expenditures in 2001.<sup>49</sup> Extrapolating from these figures, one might estimate reductions in planned local loop investment of \$575 million in 2000 and \$450 million in 2001, for a total planned reduction in the local loop of about \$2 billion. This is the same amount that MCI earlier announced it planned to invest to “invade the local telephone market.”<sup>50</sup>

In sum, over the next four years, the merged entity plans to reduce local spending by a total of \$5.3 billion compared to what MCI planned to spend in the local exchange absent a merger with WorldCom. The overwhelming portion of the \$5.3 billion in savings will be realized from the shift in MCI’s business strategy away from the residential and small business local exchange market.<sup>51</sup>

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<sup>49</sup> *Id.*

<sup>50</sup> “One Year After Telecom Act: MCI Aggressively Expands Local Service; Brings Local Networks to Six New Cities, Plans Local Service for Residential Customers in More States; MCI Committed to Serving Local Customers Nationwide,” *supra*.

<sup>51</sup> There are other financial signs that the merged entity would reduce MCI’s pre-merger planned investment in local facilities. The merged entity will have a significant debt overhang as a result of borrowing \$7 billion to purchase British Telecom’s MCI stock, reducing cash flows that might have otherwise been available for expansion.

| <b>Table 2. Post-Merger Planned Reductions in Spending<br/>in Local Residential and Small Business Market</b> |               |               |               |               |               |
|---|---------------|---------------|---------------|---------------|---------------|
|   | <b>1999</b>   | <b>2000</b>   | <b>2001</b>   | <b>2002</b>   | <b>Total</b>  |
| <b>Operating Costs</b>  | \$500 million | \$700 million | \$900 million | \$1.2 billion | \$3.3 billion |
| <b>Capital Expenditures</b>   | \$700 million | \$575 million | \$450 million | \$300 million | \$2 billion   |
| <b>Total</b>  | \$1.2 billion | \$1.2 billion | \$1.4 billion | \$1.5 billion | \$5.3 billion |
| Source: WorldCom Form 8-K, Exhibit 99.3, "MCI and WorldCom Analysts Presentation Given on Nov. 10, 1997."     |               |               |               |               |               |

### **3. The Merged Entity's Abandonment of Facilities-Based Competition in the Local Exchange Residential and Small Business Market Is Not in the Public Interest**

The merger jeopardizes the Telecommunications Act of 1996's pro-competitive policy for the local loop. Breaking up the incumbent local exchange carriers' monopoly bottleneck control of the local loop as a means to "secure lower prices and higher quality service for American telecommunications consumers" is a primary goal of the 1996 Act. Realization of this policy goal requires facilities-based competitors who, through control of their own networks, compete with incumbents based on the quality and price of new products and services. In contrast, resellers, by definition, remain dependent upon the incumbent carrier's network infrastructure, as well as service standards for maintenance, repair, and many aspects of customer service. In a reselling scheme, it is hoped that these resellers evolve into facilities builders. But should the merger go forward, the endpoint will be merger, not building of facilities. The 8<sup>th</sup> Circuit's decisions on

pricing and rebundling of network elements leaves serious doubt that rebundling will provide a means to jump-start facilities-based competition.

There is strong evidence that prior to the announcement of its planned merger with WorldCom, MCI planned to enter the local exchange residential and small business market with an aggressive local build-out and marketing commitment.<sup>52</sup> These \$5.3 billion plans will be scrapped over the next four years by the merged entity with its “religious focus” on the medium- and large-sized business customer.

Thus, the merger will eliminate the strongest potential precluded competitor for facilities-based competition in the residential and small business local exchange market. The merger will retard development of the 1996 Act’s “pro-competitive” policy and therefore fails in this regard to meet the Commission’s public interest standard. Therefore, on this basis, the Commission should deny the applicants’ request.

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<sup>52</sup> “One Year After Telecom Act: MCI Aggressively Expands Local Service; Brings Local Networks to Six New Cities, Plans Local Service for Residential Customers in More States; MCI Committed to Serving Local Customers Nationwide,” *supra*.

## **V. The Proposed Merger Will Hurt Universal Service**

### **A. The Commission Must Determine That the Proposed Merger Advances and Promotes Universal Service.**

In the Bell Atlantic NYNEX Order, the Commission states that its public interest standard for evaluating a merger can include an evaluation of the merger's impact on the goal of "preserving and advancing" universal service as articulated in Section 254 of the Telecommunications Act of 1996.<sup>53</sup> Such an evaluation must consider whether the merger preserves and advances the universal service principles outlined in the Act, including ensuring that "quality services should be available at just, reasonable, and affordable rates," "access to advanced telecommunications and information services should be provided in all regions of the Nation" and "consumers in all regions of the Nation, including low-income consumers and those in rural, insular, and high cost areas...should have access to telecommunications and information services...that are reasonably comparable...and that are available at rates that are reasonably comparable" to those in urban areas. Section 254 of the 1996 Act also mandates that contributions to universal service support should be made on an "equitable and nondiscriminatory basis."<sup>54</sup>

As part of its merger evaluation, the Commission must therefore evaluate the proposed merger's impact on these universal service principles.

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<sup>53</sup> Telecommunications Act of 1996; *Bell-Atlantic NYNEX Order*, 2.

<sup>54</sup> Telecommunications Act of 1996, § 254(b)(1-4).

**B. The Merged Entity's Vertical Integration of Exchange Access, Long Distance, and Internet Access Markets in 100 Central Business Districts Will Result in a Significant Shift of Revenues from the Public Switched Network to the Private MCI-WorldCom Network**

WorldCom, through its recent acquisitions of MFS and Brooks Fiber, is the largest competitive access company in the nation, providing exchange access to business customers in 86 metropolitan areas. WorldCom's long distance network customer base consists of 80 percent business customers; the remaining 20 percent are residential customers who purchase through a wholesale arrangement.<sup>55</sup> Less than 5 percent of WorldCom's revenue derives from the retail segment and fully 20 percent of WorldCom's revenue comes from its private line business.<sup>56</sup> WorldCom, and the firms that it has acquired, have pursued a targeted business strategy, ignoring residential customers and mass markets, while pulling high-revenue medium- and large-sized business customers off the public switched network.

A merger of MCI and WorldCom would result in a vertically integrated company ideally positioned to arbitrage business opportunities opened by the competitive, deregulatory policy of the Telecommunications Act of 1996. The merged entity would own more than 9,000 miles of fiber ringing the central business districts in 100 urban markets; a 45,000 mile long-distance network with 25 percent market share; 63 percent of the Internet backbone network and the

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<sup>55</sup> "WorldCom: The I's Have It; International and Internet Fuel a Great Growth Story," *supra*, p. 8.

<sup>56</sup> *Id.*, pp. 4 and 8.

largest Internet service providers. The merged entity would have a customer base of 22 million customers.<sup>57</sup>

In their application for transfer of control, MCI and WorldCom state that “by linking WorldCom’s local facilities to MCI’s long distance customer base, the combined company will substantially enhance its effectiveness in competing with the incumbent local exchange carriers.”<sup>58</sup> But in reality the merged entity will not be a competitor *in all markets* served by incumbent local exchange carriers. Rather, as discussed in Section IV above, the merged entity’s business plans build upon WorldCom’s past business strategy--to achieve high margins by targeting lucrative medium- and large-sized business customers. Through vertical integration, the merged entity will be able to attract high revenue business customers by providing a bundled package of exchange access, long distance, and Internet access provided entirely on its own network. The result will be a diversion of revenue off the public switched network and accelerated bypass access charges, beyond that envisioned in the May 1997 access reform order.

### **C. The Increase in Access Charge Bypass by the Merged Entity Will Undermine Universal Service**

In its Access Reform *First Report and Order*, the Commission notes that access charges have historically provided an important (albeit not the only) source of implicit support for universal

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<sup>57</sup> “MCI WorldCom — A New Era Communications Company,” (<http://www.mci.com/aboutus/company/news/wcom/fact.html>).

<sup>58</sup> In the Matter of Applications of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications Corporation to WorldCom, Inc., CC Docket 97-211, Nov. 21, 1997, p. 34.

service. Historically, access charges paid by interexchange carriers to the incumbent local exchange carriers have included a component which subsidizes the high costs incurred by the incumbent LECs to provide a ubiquitous local network.<sup>59</sup>

Such a system of implicit support for universal service is no longer sustainable in a competitive environment. Congress recognized this by mandating that the Commission adopt universal support mechanisms that “to the extent possible” “should be explicit and sufficient”<sup>60</sup> Congress left to the Commission the difficult task of resolving how to advance and preserve universal service through explicit support mechanisms within a competitive, deregulatory framework.

In its Access Reform *First Report and Order*, the Commission concluded that “the conversion of the existing web of implicit subsidies to a system of explicit support would be a difficult task that probably could not be accomplished immediately.”<sup>61</sup> Rather, the Commission concluded that “the Act does not require, nor did Congress intend, that we immediately institute a vast set of wide-ranging pricing rules applicable to interstate and intrastate services provided by incumbent

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<sup>59</sup> In the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, End User Common Line Charges, *First Report and Order*, CC Dockets No. 96-262, 94-1, 91-213, 95-72, May 16, 1997, 11 (hereinafter *First Report and Order*).

<sup>60</sup> Telecommunications Act of 1996, § 254(c)(e). The phrase “to the extent possible” comes from the legislative history of the 1996 Act. See Joint Explanatory Statement at 131 (“To the extent possible, the conferees intend that any support mechanisms continued or created under new section 254 should be explicit, rather than implicit as many support mechanisms re today.”)

<sup>61</sup> *First Report and Order*, 9.

LECs that would have enormously disruptive effects on ratepayers as well as the affected LECs.”<sup>62</sup>

The Commission concluded that it should adopt a market-based approach to access charge reduction that would allow a “phased-in plan that relies in part on prescription and in part on competition to eliminate subsidies.”<sup>63</sup> The Commission wrote that “eliminating them (e.g. access charges) all at once might have an inequitable impact on the local exchange carriers.”<sup>64</sup>

The Commission’s carefully crafted phased-in reduction of access charges serves the purpose of allowing incumbent local exchange carriers a transition period to recover historic costs incurred to meet past universal service obligations, obligations imposed by public policy. The gradual reduction in these implicit support mechanisms is designed to provide incumbent local exchange carriers sufficient revenue so that they can continue to meet provider of last resort obligations and to maintain and upgrade the public switched network without the need to raise residential rates or to reduce network investment in the local loop.

But a merger between MCI and WorldCom would undermine the economics of the transition mechanism in two ways. First, the merged entity’s vertically integrated network in 100 urban centers would enable it to bundle exchange access, long distance, and Internet access to business

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<sup>62</sup> *Id.*, 10.

<sup>63</sup> *Id.*, 15.

<sup>64</sup> *Id.*, 9.

customers and shift a substantial portion of revenues off the public switched network. Incumbent local exchange carriers are currently unable to provide similar packages due to a variety of regulatory and legal barriers, including regulated access prices and Section 271 prohibitions against providing long distance service.<sup>65</sup>

Second, the merged entity's vertically integrated network would accelerate access charge bypass, reducing access charge revenues significantly below that envisioned by the Commission in the Access Reform *First Report and Order*. MCI and WorldCom estimate "synergy" savings in "domestic line costs" of \$1.5 billion in 1999 and \$1.2 billion in 2002.<sup>66</sup> While MCI and WorldCom do not explain the source of these "domestic line cost" savings, it is most likely that the savings derive from access charge bypass. Assuming savings in 2000 and 2001 of \$1.3 billion and \$1.4 billion, respectively, the total access charge savings over the four years comes to \$5.4 billion.

The combination of these two factors--the accelerated migration of lucrative business traffic off the public switched network and the increase in access charge bypass--would lead to significant revenue loss by incumbent local exchange carriers who continue to have carrier-of-last-resort obligations. The resulting loss in revenue is likely to result in pressure by incumbent LECs to

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<sup>65</sup> Section 271 prohibitions on Bell Operating Company entry into long distance are uncertain, pending appeal of recent court decisions.

<sup>66</sup> WorldCom Form 8-K, Exhibit 99.3, *supra*.

raise residential rates, particularly in high-cost areas, decisions to reduce network investment, or both.

The result would be contrary to the universal service principles as enumerated in Section 254 of the Act: to ensure just, reasonable and affordable rates; to promote access to advanced telecommunications and information services in all regions of nation; and to ensure access at comparable rates and of comparable quality to those in rural, insular, and high cost areas.

For this reason, the vertical integration that would result from an MCI-WorldCom merger is not in the public interest and the Commission should deny the applicant's request.

#### **VI. The Proposed Merger Will Reduce U.S. Employment Growth by Over 75,000 Telecommunications Jobs by the Year 2002**

We have used a conservative methodology to estimate the employment impact of the merged entity's planned reduction in capital and operating expenses in the year 2002. We calculate that the reduced network build-out in the local and long distance markets, combined with the reduction in customer service in the local exchange market, translates into the loss of 75,000 telecommunications jobs that would have been created by the year 2002, absent the merger. We describe the methodology below.

*Capital Expenditures.* In 2002, the merged entity plans to cut \$1.6 billion in capital expenditures (\$1.3 billion in long distance/international/Internet and \$.3 billion in local).<sup>67</sup> This translates into the loss of 35,000 jobs. We derive this figure based on the following methodology. First, we estimate average annual compensation, including wages and benefits, for non-union telecommunications craft work at \$45,000. Second, we divide the \$1.6 billion cut in capital expenditures by this average annual compensation of \$45,000. Rounding down, we arrive at 35,000 jobs lost due to the merger-related cuts in capital expenditures.

*Operating Costs.* In 2002, the merged entity plans to save \$2.5 billion in job-related operating expenses (\$1.2 billion in MCI local savings and \$1.3 billion in core sales, general, and administrative expenses).<sup>68</sup> We generously estimate that half these savings are non-personnel related: real estate, advertising budgets, etc. This leaves us with an estimate of \$1.25 billion in personnel-related SG&A savings by 2002. We estimate average annual compensation for non-union sales, marketing, customer service, and clerical occupations at \$30,000. We divide the \$1.25 billion cut in personnel-related SG&A expense by this average annual compensation of \$30,000. Rounding down, we arrive at 40,000 jobs lost due to merger-related cuts in SG&A.

*Total Telecommunications Job Loss.* The total merger-related job loss in telecommunications due to reduced network investment and operating costs is 75,000 jobs in the year 2002.

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<sup>67</sup> *Id.*

<sup>68</sup> *Id.*

A MCI-WorldCom merger would not realize a key promise of the Telecommunications Act of 1996 to create more and better jobs. In this area, too, the proposed merger falls far short of promoting the public interest, and therefore, the Commission should deny the applicants' request.

## **VII. Conclusion**

The Telecommunications Act of 1996 promised a new world of information age services that would expand access to advanced telecommunications services through lower prices, investment in new facilities, improved service quality, and employment growth. Competition was to drive these positive results. The promise of the Act is yet to be realized and competition is yet to develop as anticipated when the Act passed.

Rather, in the two years since its passage, the Telecommunications Act of 1996 has unleashed an unprecedented level of corporate mergers and acquisitions as telecommunications firms seek to strengthen their market position in a rapidly changing environment. The Commission must carefully evaluate each merger on a case-by-case basis. Some mergers may strengthen competition by ensuring that the merged firm has the resources necessary to compete; on the other hand, mergers that result in dominant market power are not in the public interest.

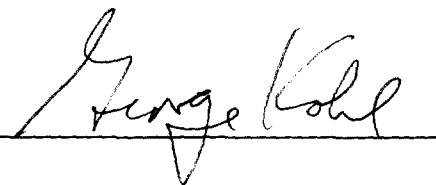
The Commission must carefully review this merger since MCI, WorldCom, and the Internet are not regulated. This review provides the Commission its single opportunity to ensure that the merger is in the public interest. It may not be an exaggeration to say that the future of

competition policy over the packet-switched data network is at a crossroads, and could well be determined by the Commission's decision in this merger review.

We have demonstrated that the MCI WorldCom merger is not in the public interest for four reasons. First, it would transform the current vibrant competitive Internet access market into one in which the merged entity would have market power to set the price of and the rules for Internet access. Second, it would delay development of facilities-based competition in the market for residential and small business customers in the local exchange. Third, it would hurt universal service. Fourth, it would reduce employment growth by 250,000 jobs throughout the economy.

Respectfully submitted,

Communications Workers of America

By 

George Kohl  
Senior Executive Director, Research and Development

January 5, 1998

## **Attachments**

# MARKETPLACE

THURSDAY, OCTOBER 2, 1997

## Would WorldCom-MCI Deal Lift Tolls on Net?

By THOMAS E. WEBER  
And REBECCA QUICK

Staff Reporters of THE WALL STREET JOURNAL  
Is the Internet about to become a toll highway?

For the first time, a single company is within reach of dominating the innards of the Internet. If WorldCom Inc. succeeds in its surprise bid to acquire MCI Communications Corp., the combined company

### ON-LINE

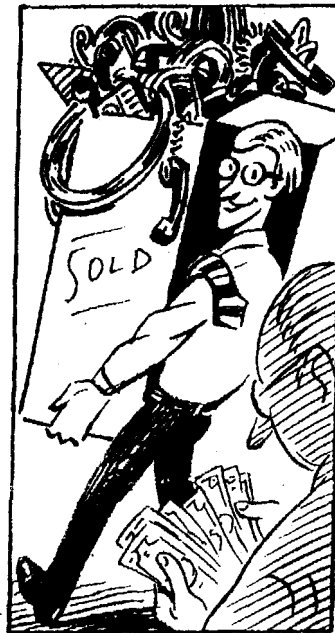
would control more than 60% of all U.S. traffic on the global computer network and a hefty share of the traffic world-wide, according to some estimates.

That kind of market dominance would give WorldCom an unprecedented level of clout and, potentially, pricing power over the Internet. For years, the innards of the Internet have functioned like the high-tech equivalent of a funky commune, with service providers freely exchanging e-mail messages and Web pages with each other's members at no charge.

But WorldCom has already made it clear it has an entirely different view of the Internet's economic model — a straightforward capitalist one. Earlier this year it began charging small Internet-access providers for the right to link up to its network.

"It's important that we have at least some minimal charge," says John Sidgmore, vice chairman of WorldCom. He says it costs WorldCom money to maintain its network and link up with other providers, and it isn't right for little players to piggyback onto the network for free.

If the old commune model turns into a free marketplace dominated by a single



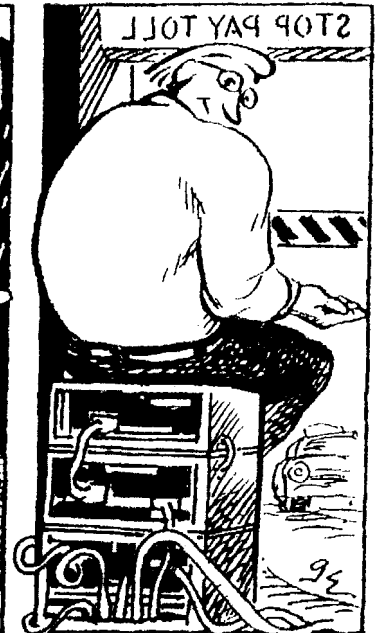
WorldCom started out buying small phone companies...



...Then moved into taking over Internet providers...



...Now its proposed MCI takeover could give it Internet dominance...



...Which some fear would lead to higher Internet prices

Gil Elsner

giant, any new charges are likely to find their way back to consumers. Ultimately, that could signal the demise of those ubiquitous \$19.95-a-month unlimited-access plans.

"Flat-rate pricing isn't likely to last under this model," says Don Heath, president of the Internet Society, a Reston, Va., nonprofit group that advises on Internet policy. An MCI merger, he says, "could ultimately mean too much control" for WorldCom.

Indeed, the Justice Department will examine whether the proposed merger would violate antitrust laws. WorldCom, meanwhile, says it is confident the deal will pass muster by early next year.

Mr. Sidgmore has long been an outspoken critic of the industry's flat-rate pricing, which doesn't discourage users from overloading the already clogged Internet. But he said yesterday he has no plans to raise the prices he charges for access to WorldCom's network.

Yet many expect the industry's consolidation to ultimately change its pricing schemes. Users could find themselves paying based on how long they stay on-line, how much data they send and receive, or even how quickly the data are beamed over the Internet.

The smaller Internet service providers who link up to WorldCom's network are anxious about what will happen. "I'd say it's a whole new game," says Kent Eng.

Please Turn to Page B20, Column 5

# Would Tolls Increase On Net if WorldCom Made Deal With MCI?

*Continued From Page B1*

land, vice president of technology at GeoNet Communications Inc., a midsize Internet access provider in Redwood City, Calif. "At this point, maybe [WorldCom executives] can throw their weight around."

Having one company hold such power would be a first for the Internet. Though the network started off as a bomb-proof communications system for the U.S. military, its growth has been driven by the thousands of computer networks, large and small, that have hooked up to it in recent years under a loose confederation. It is often remarked — and at times, even lamented — that no one really governs the Internet.

The proposed deal could spur a drastic realignment because of the Internet's structure. Most consumers reach the Internet through an on-line service or an Internet service provider. Those companies range in size from giant America Online Inc. to thousands of local providers with just a few hundred customers each.

But like the side streets of a city, all of these providers eventually connect to a main highway — in this case, the giant Internet pipelines called backbones. The companies that operate these backbones — which essentially are the Internet — provide the crucial link for on-line services and Internet service providers. They also charge corporate customers to hook up directly to these pipelines.

By long tradition, the Internet's various networks have agreed to pass along each other's traffic. Everyone was considered a "peer," and the peer agreements required that no single link on the network would charge a special toll for traffic to pass through its system.

But lately, as large network operators have spent millions to make their backbones bigger and faster, they have been increasingly reluctant to share the benefit of those improvements with smaller players for free. Earlier this year, WorldCom roiled the ranks of smaller Internet service providers when it suggested it would reduce the number of its "peering" agreements and instead would start charging small Internet access providers for access to its backbone.

Indeed, WorldCom says it has canceled a few of its peering agreements since then. But the company says that it considers the fees it charges insignificant, sometimes as low as \$1,000 a month for backbone access.

WorldCom has clout because over the past year it has been buying up those main highways. Late last year, it paid \$14.4 billion for phone company MFS Communications Corp., which owned Internet-backbone operator UUNet Technologies.

Last month, WorldCom entered into a complex transaction to purchase CompuServe Corp.'s network and an Internet backbone owned by America Online called ANS Communications.

Acquiring MCI and its substantial Internet-backbone business would mark the biggest step yet in an expensive buying spree. But whether WorldCom's increased power over the Internet's backbones would violate antitrust laws is a matter for the Justice Department to decide. People close to the matter say the department is already exploring similar issues in WorldCom's pending \$1.45 billion purchase of the networks of CompuServe and AOL.

A key question for antitrust enforcers: If prices go up, could customers seek an alternate provider? Moreover, regulators aren't likely to be concerned if they conclude that new competitors could easily enter the market. They also must decide whether the Internet backbone is a market unto itself or just a subset of the larger telecommunications market, which includes many other players.

"There're an awful lot of backbone providers out there," says Gary Miller, chief executive of Aragon Consulting Group in St. Louis, which works for several Baby Bells and other carriers. "I think the regulators are going to be hard pressed to think of any reason why this thing shouldn't go through."

Muddying the issue is the fact that few agree on how to measure control of the backbones, and operators have been loath to reveal data about their traffic volume for competitive reasons. WorldCom's Mr. Sidmore yesterday disputed industry estimates that the combined WorldCom-MCI market share would be about 60%, but said "I don't know what the right numbers are." MCI has been reported to have 35% to 40% of domestic Internet traffic, and WorldCom's UUNet has boasted that its Internet business is even bigger than MCI's.

Still, most agree that a WorldCom purchase of MCI would mark the biggest step yet in the industry's consolidation. At the bottom, small Internet service providers unable to afford "peering" fees could find themselves out of business. At the top, there will be one fewer backbone operator.

—Bryan Gruley  
contributed to this article.

MCI- WorldCom faces Internet probe...

CUKIER, KENNETH

CommunicationsWeek International Nov 24, 1997 p. 1

U.S. regulators are poised to take the unprecedented step of investigating the impact a combined MCI-WorldCom would have on the Internet before it approves the deal.

If the merger goes through, the new company may control up to half of all U.S. domestic Internet traffic.

As a result, the merger is concentrating U.S. regulators' minds on the Internet's commercial structure and what might happen if a single company achieves a dominant position. "It's not just the long distance network, but the implications for the Internet backbone," said a wellplaced official at the Federal Communications Commission, who asked to remain anonymous. "The Commission will have to think very directly on what the implications will be."

Other FCC officials confirmed that the Commission will examine the matter, but say it is too early to know if it might reject the deal or place conditions on the new company. Either way, it will mark the first time the FCC has formally examined "the merger's effect on competition on the backbone," said an FCC official.

A Department of Justice investigation, customary for mergers of this magnitude, is already under way, and officials have said they will scrutinize the Internet dimension.

In recent investigations, such as those into the Bell Atlantic-Nynex union, and the aborted BT-MCI affair, the FCC placed conditions on the companies--characterized by the Commission as "pro-competitive"--for the deal to pass.

The FCC has long maintained that the Internet sector should remain unregulated, yet with four new commissioners appointed this autumn, doubts have arisen over whether this approach can continue in what marks the commissioners' first key policy test.

Consolidation of the Internet backbone represents the industry's most fractious debate, as the Net transforms from its academic origins into a commercial entity. The fear among network engineers, industry executives and regulators is that such connectivity concentrated in a single player's hand may lead to market abuse, as the dominant player may seek tough interconnect concessions from other Internet service providers--both small and large--that need to reach the global Internet.

"If one company had a large enough share of the market," noted Gerald Brock, an interconnection expert at George Washington University in Washington DC, "then it could use its dominant position to either take over the market or extract payments from the smaller companies."

If the merger is approved by U.S. regulators, 50-55% of backbone Internet traffic will pass over facilities owned by Jackson, Mississippi-based WorldCom Inc., estimated Michael Kleeman, a consultant at the San Francisco office of the Boston Consulting Group.

During the past year, peering agreements among ISPs have been severely shaken up, while the number of backbone ISPs has plunged due to acquisitions, notably by UUNet Technologies Inc., the Fairfax, Virginia-based ISP subsidiary of WorldCom (CWI, 5 May and 22 September).

As a result of the consolidations and subsequent tough peering policies, the prices for Net access could jump. "The power of many is OK-I'm worried about the power of one," said the lead network engineer of a tier-one U.S. backbone ISP.

Smaller ISPs still cautious

The more vulnerable mid-sized ISPs remain cautious. Walter Prue, technical manager of the Los Angeles, California-based ISP Los Nettos, which buys upstream transit from MCI, said the force of the combined companies "could lead to higher prices in the future."

And the pace of consolidation is quickening. GTE Corp., of Stamford, Connecticut, this month acquired the San Francisco-based backbone Genuity Inc. from the privately held Bechtel organization. The terms of the deal--which gives GTE seven Web hosting centers--were not announced. In May, GTE acquired the fourth-largest U.S. ISP, BBN Corp.

In an apparent attempt to preempt regulators, WorldCom downplayed the Internet dominance of the combined companies when it made its bid for MCI in October. "It's still a small amount of Internet traffic on a worldwide basis," said John Sidgmore, chief operations officer of WorldCom and president of UUNet.

Doubts over Sidgmore's claims However, industry executives doubt Sidgmore's claim. "We all know that the majority of the traffic is in the United States, and it is also clear that UUNet has a significant presence in Europe and MCI has a lot of international connections," said Frode Greisen, the general manager of the pan-European backbone, Ebone, in Copenhagen. "It could well be half of the backbone traffic internationally."

In similar examinations, the FCC has typically lumped all data communications business under a single umbrella. In this case, industry executives note, the Commission will need to decide whether the Internet sector must be treated as a separate entity.

Despite the expected FCC investigation, regulators and policy makers in the United States say they are committed to a hands-off regulatory approach.

Billy Tauzin, the Republican representative from Louisiana and chairman of the House subcommittee on telecommunications, said before a congressional hearing in October that even if the combined company controls 60% of U.S. Internet traffic, there is healthy competition, since many rivals exist or are forming.

Washington against Net control A bill was introduced into Congress this year to prohibit the FCC from regulating the Internet. Although it has no bearing on an FCC review of the merger, it is indicative of Washington's reluctance to wield a regulatory stick.

The FCC has a swath of complex regulations for basic telephony service, yet maintains a laissez-faire attitude for so-called "enhanced services," of which the Internet is one. Yet the FCC has experience regulating data communications: in 1995 it treated frame relay and X.25 networks as a basic service, and placed filing requirements on interconnection agreements among providers.

The Internet is trickier. As a network of networks based on a model of trust, nothing mandates a particular provider to interconnect with another. When private backbones first appeared in the early 1990s, the U.S. National Science Foundation, which funded Internet development, required networks hosting government-funded research institutions to interconnect with other backbones.

Now, as the private sector dominates Internet backbone provision, the lack of interconnection requirements risks breaking up the Net, say engineers, since nothing prevents a dominant ISP from refusing to interconnect unless a settlement is paid for exchanging traffic.

The issue becomes further complex when considered internationally. ISPs outside the United States are understandably less worried about peering but more concerned with the settlement fees they currently pay and the fact that they must bear the full price of circuits to the United States. The protests, lead by Australian carrier Telstra Corp., has led the Organization of Economic Development to considering tackling the matter (CWI, 3 November).

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HD WHY BERNIE EBBERS WANTS TO BE THE INTERNET'S MR. BIG  
\* THE MCI-WORLDCOM DEAL ILLUSTRATES WHY DATA MEAN  
EVERYTHING TO THE TELECOMMUNICATIONS INDUSTRY.

BY ANDREW KUPFER

PD \* 12/08/97

SN Fortune Magazine

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LP \* Bernie Ebbers' audacious gambit to buy MCI, a company three times

\* the size of his WorldCom, is about more than Jonah trying to swallow the whale. This deal, along with others it has overshadowed, shows how much the telecom industry has been swallowed by the Internet. Control of the pipes that carry data is the name of the game--perhaps to the point where customers are left on the sidelines.

\* Even before MCI accepted WorldCom's offer, a clear sign of an about-face in the telecom business had come--not from a merger but from a split, as U.S. West announced it would sell its cable-TV operations. That move forever kills the idea that cable companies are natural allies of local telephone companies. Not long ago, communications executives were betting that the telephone and cable industries would converge, each type of network evolving to look more like the other. That never happened; the convergence proved too costly.

TD Then came the Net, and telecom executives changed their focus. Shelving plans to invade each other's markets, telephone and cable companies are racing to offer high-speed data services. Phone companies are introducing a new technology called ADSL (asynchronous digital subscriber line) that permits fast Internet access over ordinary copper phone lines. In Phoenix this fall, US West introduced the first commercial service. Cable companies are investing in special modems that do the same over cable systems.

But the boldest data play belongs to Ebbers, who, you can argue, is trying to buy the pipes that run the Internet. If he succeeds, the cozy collegial atmosphere that exists among Internet service providers will be gone. As of now, any ISP can send traffic onto the Net without a fee at a variety of public entry points. But so many little providers are using these gangways that they have become chokepoints. To avoid them, the dozen biggest Internet companies have so-called private peering agreements to carry one another's traffic over their own data networks for free.

These arrangements assume that Internet companies will hand off traffic to one another in roughly equal volumes. But the WorldCom deal means that three of the biggest data networks--MCI's, WorldCom subsidiary UUNet's, and a network WorldCom recently bought from America Online--will all be under Ebbers' control, giving him an estimated 40% of the Internet backbone, the high-speed network that carries data around the country. Ebbers will be able to rely less on the others, while the others will need him more, which may mean more money for him.

Ebbers argues that worrying about the peering agreements is absurd. "We think that people who use the Net ought to pay at least a little bit for it," he says. MCI-WorldCom's Internet presence is sure to draw Justice Department scrutiny, but regulators may decide that Ebbers doesn't have crushing market power. After all, other companies, notably GTE, are building high-speed data networks. Willkie Farr & Gallagher attorney Philip Verveer, who helped prosecute the AT&T antitrust case, says WorldCom wouldn't have a lock on the Internet transport business since the factors of production (routers, fiber) are readily available.

Ebbers doesn't want to stop at the border. WorldCom is building a high-speed data network in Europe, and, with Britain's Cable & Wireless, it is laying its own trans-Atlantic fiber-optic cable, which will let the company carry traffic to Europe without leasing circuits from anyone else. That could make WorldCom the low-cost international data carrier. "If you buy off on the models of the consulting gurus, the Internet is growing so fast that data traffic will dwarf voice traffic," Ebbers says. "There's going to be a tremendous demand for bandwidth."

So Ebbers wants to own as many of the pipes as he can. But will he be able to fill them? He may have hurt himself by backpedaling from Concert, the joint venture between British Telecom and MCI that sells worldwide telecom services to multi-national customers. (The MCI-WorldCom deal will allow BT to buy back MCI's stake in the venture.) This service has enormous appeal to business customers and is MCI's only differentiation from AT&T and Sprint, argues telecom analyst David Goodtree of Forrester Research. "MCI WorldCom will lose multinational customers, kit and kaboodle," he says. MCI says it will still distribute Concert services, but BT may sell them through other telecom companies.

For now, Ebbers' main worry is keeping WorldCom's stock price from falling any lower. It has sunk 25% from its recent high, to around \$30--close to the minimum price at which its offer for MCI will be worth \$51 a share. For every dollar WorldCom falls below \$29?, the value of its bid for MCI declines by \$1.75 a share. A few more dollars, and it will be within range of GTE's cash offer, said to be \$45 to \$46 a share. Says GTE Chairman Chuck Lee: "For GTE shareholders, \$51 per share is too much, but we certainly haven't precluded other options."

Quote: EBBERS' MAIN WORRY IS KEEPING WORLDCOM'S STOCK PRICE FROM FALLING ANY LOWER.

## **WorldCom, MCI and the Internet**

**Bhawani Shankar**

12/01/97

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LONDON - If the bid by WorldCom for MCI is endorsed by shareholders and regulators, the merged company would obtain enormous influence over the development of the Internet. The Net began as a disorganised, decentralised network of networks. There is no owner, no central guiding force, just a collection of standards and some voluntary bodies to administer them. But recently a handful of big companies have built up powerful roles in providing access to the Internet and carrying its data.

WorldCom owns UUNet, the biggest and most international of the Internet service providers (ISPs), which link users to the net. Recently, it agreed to buy the network infrastructure of America Online and CompuServe, two proprietary on-line systems which also act as ISPs. Similarly, MCI provides the most heavily used of the fibre-optic backbones for the system in the US.

But the Internet industry is far from mature - more fiberoptic backbone capacity is being added daily, worldwide. With the many thousands of small ISPs and other big Internet players, such as Sprint, AT&T, Unisource and Global One, it may still be too early to say that a merger between WorldCom and MCI would produce an undesirable concentration of power. Nonetheless, there is a risk that the consolidation of the industry will transform the way the Internet works.

From the outset, Internet players have carried each others' data across their networks for free. It is this arrangement that gave the system its low cost and global reach. As individual participants get bigger, there is a growing temptation for the larger to discriminate against the smaller, charging them for access or refusing connections altogether. So far, the shift to charging has not destroyed the Internet ethos; it may, indeed, be a desirable step towards maturity and financial stability.

The proposed merger unites two of the biggest US-based companies in the emerging Internet industry, together handling around 60 per cent of domestic backbone traffic. For the US regulator, the Federal Communications Commission, it provides an ideal opportunity for an examination of the competition issues.

The ramifications of the deal for regulators in Europe keen on streamlining the Internet are still unclear. Through its ownership of MFS, WorldCom owns considerable amounts of fibre in the UK, Germany and France. It also has interconnects in various other European countries as well as in Hong Kong and the Far East. The federal authorities should rise to this challenge. This means that a combined UUNet-CompuServe-America Online Internet services company would not only be the largest ISP in the world, but would also be the only one to have free access to the most extensive backbone infrastructure.

But analysts point out that the three ISP members of the WorldCom family are all very different players. UUNet has sold itself on the basis of its so-called "industrial strength Internet access," while the other two are content-based information providers. But the fact remains that each of the three ISPs will now have the best global

WDP 10/4/97

# WorldCom Clarifies MCI Plans

## Sidder Pledges It 'Will Not Abandon' Residential Customers

By Mike Mills  
Washington Post Staff Writer

WorldCom Inc. yesterday said it plans to continue serving all of MCI Communications Corp.'s 20 million residential long-distance customers, should it succeed in its unsolicited bid to buy MCI for \$30 billion.

The statement came in response to an article in yesterday's Washington Post that quoted WorldCom Vice Chairman John Sidgmore about the potential benefits of moving MCI out of the consumer long-distance business, if the merger goes through, to focus exclusively on business customers.

A WorldCom statement yesterday said: "WorldCom will not abandon MCI's residential long-distance customers." But it did not elaborate on its plans for the residential business.

Under a possible strategy outlined by Sidgmore in the article, WorldCom would turn MCI's residential customers over to other long-distance companies, which would handle billing and customer service. Those companies would purchase wholesale long-distance capacity from WorldCom and MCI but serve former MCI customers under their own brand names.

In an interview upon which the article was based, Sidgmore talked about that course as a "possibility" or something that "we would consider." The first sentence in The Post's article said that MCI "would jettison" the residential customers if the acquisition goes through. Business section Assistant Managing Editor David Ignatius said yesterday that the wording was stronger than Sidgmore's remarks warranted.

At the same time, Sidgmore talked in detail about the benefits WorldCom and MCI would enjoy by getting out of residential long-distance calling, which generally is a low-profit business. "Our religious focus is on the business customer," he said. "It is a jihad. This other market is something new."

Analysts said that WorldCom's shareholders would support the company's steering away from residential business, in which growth has been slowing amid intense competition in the past year.

But such a move would not be at all popular with MCI management—which still is analyzing the buyout offer—or with employees, or customers, analysts said.

Some industry analysts also were critical of any such strategy. "Breaking it up so you can keep business customers, and farming out the residential customers, serves WorldCom's purpose, I guess. But it's just unsettling," said telecom analyst Jeffrey Kagan of Kagan Associates in Atlanta.

"If it was any other company than MCI, it would make perfect sense," said Kagan. "But you're dealing with an MCI, which is the number two

long-distance company. It's near and dear to the hearts of their customers and to America."

"MCI broke up Ma Bell," he said, referring to the court battle that helped bring about the dismantling of the AT&T monopoly phone system in 1984.

Such a change for MCI likely would capture the attention of regulators who would have to approve any WorldCom-MCI merger. "This is clearly a factor that the commission would want to look at, along with a lot of other relevant factors," said one official at the Federal Communications Commission last night.

Yesterday WorldCom moved its offer forward on the legal front, asking a Delaware court to strike down a provision in MCI's pending merger agreement with British Telecommunications PLC that would protect it from hostile takeovers from other companies. WorldCom also asked the court to allow MCI to escape paying BT a \$450 million breakup fee if MCI pulls out of that deal.

WorldCom shares closed yesterday at \$38.06¼, up 18¼ cents. MCI finished trading at \$36.18¾, down 43¾ cents.

***WorldCom Would Shift MCI's Focus; Bidder Plans ...***

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WP9727600125

A Section

\* WorldCom Would Shift MCI's Focus; Bidder Plans to Shed Residential Service

Mike Mills

Washington Post Staff Writer

835 Words

5742 Characters

\* 10/03/97

The Washington Post

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MCI Communications Corp. would jettison its approximately 20 million residential long-distance customers and focus solely on more profitable business customers if a proposed \$30 billion buyout of MCI goes through, according to a top official of the company that would make the purchase.

\* John Sidgmore, vice chairman of WorldCom Inc., said in a telephone interview that the residential customers likely would be transferred to other long-distance companies, potentially including the regional Bell companies.

For example, he said, "an MCI customer would become a Bell Atlantic customer."

\* Under this scenario, calls would still be carried by WorldCom and MCI wires. But the job of setting rates, providing operators and billing the customers would belong to the other companies. The customer would never hear the MCI name or deal with the company.

\* WorldCom would "sell" MCI customers to other long-distance companies, who would pay for rights to serve established accounts. Because customers are legally guaranteed the right to choose their long-distance provider, they would not have to stay with the company they were moved to.

Precisely when and how all this would occur is unclear: Even

\* under the speediest scenario, WorldCom would have to wait until next year to buy MCI. "We're not saying [the end of residential service] is definitely going to happen on day one," Sidgmore said. Initially "we're going to market to consumers just like MCI does. On the other hand, our strategy is not in the consumer business."

"It's very difficult for us to find a way to make economic sense out of the advertising budgets, the customer service budgets, etc., required to be in the consumer business. We might be willing to